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In the Supreme Court of the United States

OCTOBER TERM, 1948.

No. . . . . .

THE LOCKE MACHINE COMPANY,
Petitioner,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI.

To the Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States:

Petitioner prays that a writ of certiorari issue to review the judgment entered by the United States Circuit Court of Appeals for the Sixth Circuit, on May 17, 1948, in cause No. 10,577 on the docket of said court, wherein said court affirmed, 168 F. (2d) 21 (R. 151, 153) the decision of the Tax Court of the United States, 6 TCM 294, CCH Dec. 15,678(M) (R. 128-41), determining against petitioner a deficiency in income and excess profits taxes.

The case presents a problem of statutory construction; it raises the question, never heretofore passed upon, whether there is any basis for the power the Commissioner has come to exercise, of fixing the compensation an employer will be permitted to pay.

JURISDICTION.

This Court has jurisdiction to review said judgment under Sections 1254(1) and 2101(c) of the new Judicial Code, effective September 1, 1948.

The judgment was entered May 17, 1948 (R. 151). Petition for rehearing (R. 159), duly filed, was denied June 21, 1948 (R. 171).

STATUTE INVOLVED.

The case turns on Internal Revenue Code Section 23(a)(1)(A), which reads:

> "**Sec. 23. Deductions from Gross Income.** In computing net income there shall be allowed as deductions:
>
> (a) EXPENSES.—
>
> (1) TRADE OR BUSINESS EXPENSES.—
>
> (A) IN GENERAL.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *."

STATEMENT OF FACTS.

The Tax Court determined a deficiency in income and excess profits taxes for the year 1941 (R. 128-41).

The Circuit Court of Appeals affirmed (R. 153).

The additional tax results from disallowance, as an expense in computing income subject to tax, of part of the compensation paid by the company to four officers and employees (R. 128, 139). There is no claim that what the company paid was not compensation or that it should be disallowed on any ground save only that the company paid too much. The sole ground of the disallowance was that the company paid "excessive compensation" (R. 10, 129, 133, 139).

The compensation paid consisted of modest base pay, which is not questioned, plus a year-end bonus (R. 29) determined in accordance with a plan instituted in 1927 (R. 25, 131), modified in 1928, 1929 and 1930 (R. 26-7, 131), placed on a percentage basis in 1931 (R. 27, 131-2), and thereafter continued in effect unchanged, save only for a downward revision in 1941 (Ex. 4-D, R. 25-8, Ex. 5-E, R. 29, 131-2).

Under the plan, after setting aside an amount equal to 10% of the outstanding stock, the following percentages of earnings were to be paid as a bonus (R. 27-8, 132):

Employee	Percentage
Elbert H. Baker, Jr., Vice President and General Manager	9%
Edward C. Sinclair, Plant Superintendent	8
J. E. Tomer, Secretary and Assistant Treasurer	7
Otto Gammel, Office Manager	5

This plan had been in effect since 1931 except that Baker, Sinclair and Tomer initially were the only participants and their percentage participations were, respectively, 10, 9 and 8 percent (R. 131-2). In 1941 the plan was extended to cover Otto Gammel (R. 27-8, 132). To make provision for him, the three, who had been participants since the commencement of the bonus plan, surrendered each one percentage point, making their participation 9, 8 and 7 percent, and Gammel 5% as above set forth[1] (R. 27-8, 132). It is not claimed that this division bore any relationship to stock ownership. While Baker owned a substantial stock interest, the other three involved owned each but 10 shares

[1] To compensate for the surrender by each of the three of one percentage point, an upward adjustment was made in base pay (R. 56). As it turned out, Sinclair and Tomer received in 1941 less than they would have received had no such adjustment been made. The total compensation which would have been payable to the three, had no change been made, as compared with the amount actually paid, was (R. 130, Ex. 12, R. 127):

	Effect of Change in 1941		
Employee	Total Paid in 1941	Amount Called for under 1931 Plan	Difference
Baker	$29,039	$25,198	$3,841
Sinclair	17,399	18,358	— 959
Tomer	14,999	16,079	— 1,080
		Net change	$1,802

out of a total of 675, increased at the end of the year to 27 each out of the 726 shares then outstanding (Ex. 8-H, R. 34).

The amounts paid including base pay and bonus, the amounts allowed by the Commissioner and by the Tax Court (affirmed by the Circuit Court of Appeals), and the amounts disallowed (omitting cents) were (Ex. 5-E, R. 29, 129, 130, 139):

	Total Compensation Paid			Amounts Allowed by		
Employee	Base Pay	Bonus	Total	Commissioner	Tax Court (affirmed by Circuit Court)	Disallowed
Baker	$15,000	$14,039	$29,039	$16,000	$16,000	$13,039
Sinclair	4,920	12,479	17,399	9,000	10,000	7,399
Tomer	4,080	10,919	14,999	8,000	8,000	6,999
Gammel	2,760	7,799	10,559	3,500	7,500	3,059
Totals	$26,760	$45,236	$71,996	$36,500	$41,500	$30,496

All of these men had been with the company for many years, Baker for 23, Sinclair for 14, Tomer for 20, and Gammel for 8 (R. 130-1). They stayed with the company in reliance upon the assurance that if they built up the business they would be compensated through the bonus plan in proportion to the success of their efforts (R. 47-9, 79, 101-2, 107-10, 119, 121-2).

If the Commissioner now may deny what was promised, these men will have given the best years of their lives at the cost of a crushing burden laid upon the company they have struggled to make a success in a fiercely competitive field.[2] For the effect of the decision upon this company, see R. 167-9.

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[2] The company is engaged in the business of manufacturing bicycle coaster brakes, which it sold to Sears Roebuck, and which accounted for 53% of its business, out of total sales of $715,000, and in the manufacture of other screw machine products, such as pieces for the automotive trade, refrigerator parts, gear blanks, and like items, which it turned out for various manufacturers (R. 129, Ex. 7-G, R. 32-3, 130, 90, 105-6).

QUESTIONS PRESENTED.

The questions presented are:

1. Does the Commissioner or Tax Court have any power under Internal Revenue Code Section 23(a)(1)(A), which authorizes deduction of

> "All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered,"

to disallow any part of a payment conceded to be compensation?

2. Does the statute bestow the power where the payment is made in good faith pursuant to a plan which has been in effect for many years and in reliance upon which the services have been rendered?

3. If the statute, properly read, does bestow the power, may the question whether the compensation paid was "reasonable" be made to turn on (a) the source of the earnings, (b) the need of the United States for revenue, or (c) upon a different rule in wartime?

REASONS RELIED ON FOR ALLOWANCE OF WRIT.

The writ should issue to settle important questions of federal law which have not been but should be decided by this Court, in that:

1. Whether the statute bestows the power the Commissioner has exercised, to disallow compensation paid in good faith, has never been passed upon by this Court. It has never been passed upon by *any* court save in this litigation.

The statute, which now is Internal Revenue Code Section 23(a)(1)(A), originally authorized deduction of "All

the ordinary and necessary expenses"[3] of carrying on a business. This obviously embraced compensation payments. To this all-inclusive provision, the Revenue Act of 1918 added the words here in question:

> "including a reasonable allowance for salaries or other compensation for personal services actually rendered."

As Dean Griswold has demonstrated[4] this was not designed to cut down a deduction the taxpayer otherwise would have had; it was put into the statute to give to the taxpayer a deduction he otherwise would *not* have had by giving him the benefit of "a reasonable *allowance*" for salaries where, as in the case of small family businesses, none had been paid.

However, the reason for the change having been forgotten, the Commissioner has come to treat the statutory provision as a limitation on all compensation payments. He has freely substituted his judgment for that of the employer as to what it is reasonable to pay, even where, as here, what was paid is conceded to be compensation paid in good faith pursuant to a plan of many years' standing. And, while there are cases by the bushel—although none in this Court[5]—where the courts have passed upon the Commissioner's compensation disallowances, the question whether the power was ever granted has gone by default.

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[3] Emphasis supplied throughout.

[4] NEW LIGHT ON "A REASONABLE ALLOWANCE FOR SALARIES," 59 Harvard Law Review 286. See also THE DEDUCTION OF "A REASONABLE ALLOWANCE FOR SALARIES"—THE UNDEFINED POWER OF THE COMMISSIONER, 56 Harvard Law Review 997.

[5] *Botany Worsted Mills v. United States* (1929), 278 U. S. 282, which did deal with compensation disallowances, arose before the language here in question was written into the statute and did not raise the present question. "We do not find it necessary to determine," said the Court, whether the amounts paid may be disallowed (p. 292) "merely because, and to the extent that, as compensation, they are unreasonable in amount." There the taxpayer failed because the money paid (p. 293) "was not in fact compensation for their services * * *."

Save in this case no court[6] has been called upon to examine the question whether the statute, properly read, grants the power. Instead, it has been *assumed* that the statute grants the power and the cases disposed of by examining only whether the amount paid was or was not in fact reasonable.

The question obviously is of enormous importance. If the statute does not bestow the power, the Court should stop its exercise, just as it would any other unwarranted seizure of arbitrary power.

2. If the statute does bestow the power, the Court should say by what tests the exercise of the power is to be measured. This Court has never laid down the controlling principles. It has never had occasion to do so. The last compensation case this Court had was *Botany Worsted Mills v. United States* (1929), 278 U. S. 282, which, as has been pointed out (in Note 5 on the opposite page) arose before the statute contained the provision for "a reasonable allowance."

How important it is that the governing principles be made clear, may be seen from the fact that nearly 10% of the cases filed in the Tax Court relate to compensation deductions, constituting the largest single class of litigation before the court.[7]

How sorely needed guidance is may be seen also from this case, where the Tax Court disallowed what was paid, not on the ground that it was not compensation, but because of the Tax Court's belief, in which the reviewing court saw nothing to criticize, that the reasonableness of what was paid could be made to turn on:

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[6] Except the Tax Court in *Walts, Inc.*, 6 TCM 22, CCH Dec. 15,566(M), January 17, 1947, where the point of a want of power was made but ruled against the taxpayer.

[7] The Commerce Clearing House Tax Court Petitions Index shows that, in the period from May 28, 1945 through March 8, 1948, 9,250 petitions were filed in the Tax Court (docket Nos. 8,251 through 17,500). Of these, 913 or 9.8% are classified in the index as dealing with compensation.

(a) **Source of the earnings**, the Tax Court erroneously considering the payments to be "based upon abnormal war profits" (R. 137).

The Tax Court was twice wrong: (1) the company had no "war" earnings whatsoever, but, even if it had, (2) Congress has not, except in the Renegotiation Act, made the test of what an employer may pay turn on the source of his profits.

(b) **Need of the United States for revenue**, the Tax Court erroneously considering that, if the payments be allowed (R. 138), "the Government, at a time when it needs tax income most vitally, will be unjustly deprived of such income."

Surely the compensation an employer may pay cannot be made to turn on the "need" of the United States. In any event Congress has not said so.

(c) **A different rule in wartime**, the Tax Court erroneously considering that (R. 134) "there is a vast difference between unusual profits which may sporadically befall * * * and * * * enormous profits * * * in a world-wide military conflict."

The Tax Court was thrice wrong: (1) the "enormous profits" were 7.52% on sales as compared with 7.27% in the two preceding years (Ex. 7-G, R. 32-3), (2) the earnings were no more warlike than a bicycle coaster brake sold to Sears Roebuck, which accounted for 53% of the company's earnings (Ex. 7-G, R. 32-3), refrigerator parts, terminals for street car rails, and like items (R. 90, 105-6) and (3) except in the Renegotiation Act, Congress has not made the taxpayer's rights turn on war conditions.

This Court has never passed upon the question whether the statute grants the power the Commissioner has exer-

cised, nor has the Court ever had occasion to consider the principles which shall control if the Commissioner does have the power. They should be examined.

The writ should issue.

Respectfully submitted,

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September 13, 1948.

In the Supreme Court of the United States

OCTOBER TERM, 1948.

No. .....

THE LOCKE MACHINE COMPANY,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

The writ should issue to determine whether Internal Revenue Code Section 23(a)(1)(A) bestows power upon the Commissioner to disallow compensation paid in good faith pursuant to a plan of long standing, and, if it does, to define the bounds of that power and the principles controlling its exercise.

OPINIONS BELOW.

The opinion of the Tax Court (R. 128-41) is reported in 6 TCM 294, CCH Dec. 15,678(M).

The opinion of the Circuit Court of Appeals (R. 153) is reported in 168 F. (2d) 21. Petition for rehearing (R. 159) was denied without opinion on June 21, 1948 (R. 171).

JURISDICTION.

As noted in the petition, jurisdiction is invoked under Sections 1254(1) and 2101(c) of the Judicial Code.

STATEMENT OF FACTS.

The facts are stated in the petition.

SPECIFICATION OF ERRORS.

The Circuit Court of Appeals erred:

1. In holding that Internal Revenue Code Section 23(a)(1)(A) bestows power upon the Commissioner to pass upon the "reasonableness" of compensation paid by an employer.
2. In holding that a payment, conceded to be compensation and paid in good faith pursuant to a plan which has been in effect for many years, may be disallowed.
3. In holding that whether compensation paid is "reasonable" may be determined upon the basis of (a) the source of the earnings, (b) the need of the United States for revenue, or (c) upon a different rule in wartime.
4. In affirming, and refusing to reverse, the decision of the Tax Court.

ARGUMENT.

REASONS RELIED ON FOR ALLOWANCE OF WRIT.

This case raises questions of major importance, never passed upon by this Court. They are questions of first impression.

I. DOES THE STATUTE BESTOW POWER?

Originally the statute, which now is Internal Revenue Code Section 23(a)(1)(A), authorized deduction, in computing taxable income, of "*All* the ordinary and necessary expenses"[1] of a business, thus including compensation payments.

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[1] The provision appeared in the Act of October 3, 1913, Section IIG(b). It was carried into the Revenue Act of 1916, Section 12(a), was repeated in the Revenue Act of 1918, Section 234(a)(1), and was carried forward into all subsequent Revenue Acts until codified in Internal Revenue Code Section 23(a)(1)(A).

At that time there was no power to disallow a payment conceded to be compensation. While the Government could, of course, disallow a payment if it in truth were not compensation, it was settled that the Government had no right "to inquire into and determine whether the amounts thereof are proper, that is, whether they are too much or too little."[2] *United States v. Philadelphia Knitting Mills Co.* (3 C. C. A., 1921), 273 Fed. 657, 658.

In the Revenue Act of 1918 the statutory language was changed. To the already existing provision for deduction of "*All* the ordinary and necessary expenses," was added the provision:

> "including a reasonable allowance for salaries or other compensation for personal services actually rendered."[3]

Why was the change made? Was it intended thereby to limit compensation payments to sums the Commissioner should consider "reasonable"? If it was, this would be a tremendous power—to say what the workman shall be paid—to vest in *any* administrator.

Dean Griswold has demonstrated that the change had no such purpose.[4]

The change was not designed to authorize the Commissioner to substitute his judgment for that of the taxpayer as to what he should pay where the sum paid was, in truth, compensation paid in good faith. It was designed

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[2] This, likewise, was the official view of the Treasury. Thus, in T.D. 2696, issued April 10, 1918, prior to the change in the statute, it was said:

> "The test of deductibility in the case of compensation payments is **whether they are in fact payments purely for services** or include some other element."

[3] 40 Stat. 1057. The provision for "including a reasonable allowance" appears in Section 234(a)(1) relating to corporations, and Section 214(a)(1) relating to individuals.

[4] NEW LIGHT ON "A REASONABLE ALLOWANCE FOR SALARIES," 59 Harvard Law Review 286. See also THE DEDUCTION OF "A REASONABLE ALLOWANCE FOR SALARIES"—THE UNDEFINED POWER OF THE COMMISSIONER, 56 Harvard Law Review 997.

to provide a statutory basis for the practice the Commissioner, without statutory authority, had established of making a "reasonable *allowance*" for compensation where none had been paid, as was often the case in small family businesses. The practice, although without statutory basis, was formalized in Regulations 41, Art. 39, which specified, in almost exactly the language later written into the statute:

> "An individual carrying on a trade or business * * * may in computing the net income * * * deduct *a reasonable amount* designated by him *as salary or compensation for personal services actually rendered* * * *."[5]

The purpose, as the Committee on Appeals and Review, the predecessor of the Board of Tax Appeals, now the Tax Court, pointed out in A. R. R. 6087, III—1 C. B. 128, 129:

> "**was to recognize the unfortunate and inequitable position** in which many partnerships had been placed * * *. * * * it has been the practice of the Income Tax Unit to allow a reasonable amount for partners' salaries for the year 1917, **even though none were actually paid** and no agreement existed for the payment thereof.
>
> "It is the opinion of the Committee that the *intent* of the * * * regulations, was to permit * * * a reasonable amount * * * for services actually rendered, *even though* no agreement for the payment thereof was in existence during the said year and *no payments* of salaries [had been] made."

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[5] The Regulation was issued under the Excess Profits Tax Law of World War I, under which net income was determined on the same basis as in the Revenue Act of 1916. This provision for deduction of a reasonable amount for salaries, even though not paid, was extended to individuals by Regulations 41, Art. 39, and to partnerships by Regulations 41, Art. 32, and was available also to corporations "even though the full amounts had not been formally voted as salaries" as is shown by Item 51 of the Excess Profits Tax Primer published by the Bureau of Internal Revenue in 1918.

Similarly, in *Gottlieb Bros.* (1925), 1 B. T. A. 684, where only nominal expense money had been paid, allowance for salaries was made under this Regulation, although the taxpayer (p. 685)

"had no agreement for the payment of salaries or compensation for their services."

The Board said (p. 686):

"The regulation quoted seems to us reasonable and proper * * *. It certainly does justice where a strict application of the letter of the statute would do grave injustice. It has been regularly and consistently applied by the Commissioner * * *."

Before the change was made in the statute, this practice of making a reasonable allowance for salaries even though none had been paid was well established.[6]

Manifestly, all that Congress intended when it wrote into the statute the provision for "a reasonable allowance" for salaries was to supply a statutory basis for the practice which the Commissioner, without statutory authority, had established as a matter of fairness and equity. That the change was not designed to give the Commissioner a revisory power over compensation payments generally is apparent from:

1. The legislative history. The House Committee reporting the bill (H. R. Rep. No. 767, 65th Congress, 2nd Sess.) said:

"the bill [with the language here in question included in it] allows *the same deductions* from gross income as under existing law"

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[6] See, for example, *Elmer Whitehill* (1929), 16 B. T. A. 927, and *W. W. Martin* (1928), 12 B. T. A. 1385, holding that where such deduction is allowed to the employer—where no compensation, or only nominal compensation, had been paid—the employee concerned would be taxed as though such sums in fact had been paid, and *Scheuer v. United States* (Ct. Cl., 1937), 21 F. Supp. 116, certiorari denied 305 U. S. 626, holding that where compensation in fact had been agreed upon, and paid, an additional deduction then would not be allowed.

with certain enumerated exceptions not here important. The Senate Finance Committee (S. Rep. No. 617, 65th Cong., 3rd Sess.) did not disagree, nor did the Conference Committee (H. R. Rep. No. 1037, 65th Cong., 3rd Sess.), nor was anything said in the debates on these sections of the bill in the House (56 CONG. REC. 10234, 10236, 10356, 10408 to 10430), or in the Senate (57 CONG. REC. 296 *et seq.*, and 57 CONG. REC. 301, 554, 560 *et seq.*), to indicate that anyone supposed the Commissioner's power would be enlarged by insertion into the statute of the language here in question.

Indeed, it would be strange for a Congress, which as Dean Griswold has pointed out, 56 HARVARD LAW REVIEW 997, 1000, "has always resisted any effort to put a fixed limit on salary payments" to bestow so vast a power upon the Commissioner as here is claimed, *without saying expressly that it was changing the law.*

2. The language of the statute. In the light of its setting, the language in which the Congress wrote the provision is precisely that which it would have used had it intended to formalize an existing practice; it is language it would *not* have used had it intended to bestow the power the Commissioner has come to exercise thereunder. Looking to the words used:

First, note that Congress opened the clause with the word "including." Choice of the word "including" demonstrates an intent to allow something additional. Had Congress intended a limiting office for the clause, it would have said:

> "**but not including** more than a reasonable allowance for salaries or other compensation."

Congress did *not* say so. Instead, to the already existing provision for deduction of "All * * * expenses" it *specified that something else be added.* That is why it used the word "including."

Second, note that Congress directed that "All" expenses be allowed *if* "paid or incurred," whereas when it wrote the provision for the additional "allowance" it *refrained* from writing in the requirement that the salaries, for which the allowance was to be made, must be "paid or incurred." If what Congress intended to grant was a deduction in "reasonable" amount where no compensation had been paid, it obviously would leave out of this provision—as it did—the requirement that such amount be "paid or incurred."

Third, note that Congress, in authorizing deduction of expenses "paid or incurred," did *not* impose a requirement that they be "reasonable." There would be no occasion for such limitation. If the payment were in fact a part of the "expenses," and if in fact "paid or incurred," that would be enough to warrant deduction.[7] On the other hand, in the case of services rendered but not paid for, there being no other measure, it would be natural that the deduction be limited to a "reasonable allowance."

Fourth, note the use of the word "**allowance.**" Obviously, what the Congress had in mind was not an expense incurred but an item for which an *"allowance"* should be made.

Fifth, note that Congress did not speak of "reasonable salaries"; it spoke of a "reasonable *allowance.*" The Commissioner has no right to move words from one point to another, and certainly not when that brings about a change of meaning; he is bound to take the statute as Congress wrote it.

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[7] Thus, it has been held that the Commissioner *has no power* to disallow, for example, a rent payment on the ground that the sum paid was "unreasonable." *Stanley Imerman* (1946), 7 T. C. 1030. If, however, what purports to be rent, is in fact not such, it may be disallowed. *Iron City Industrial Cleaning Corp.* (1947), 6 TCM 1,237, CCH Dec. 16,143(M).

Sixth, note that the allowance is to be made for services "*actually* rendered." This would appear to be a strange provision to put into a statute if what was in mind was a limitation of the deduction for services generally. Congress in the case of other deductions did not say that they must be for services (or goods or other items) "*actually*" rendered or supplied. If, however, what Congress had in mind was an additional deduction where no compensation had been paid it then would be natural, and sensible, to say that the allowance should be confined to services "actually" rendered.

Read in the light of its setting, the pieces fit together in a manner that would not be possible had Congress intended to bestow upon the Commissioner power to substitute his judgment for that of the taxpayer. Read in the light of history, what otherwise seems an awkward and highly unusual use of words, becomes clear and natural. Every word is given its place and made to bear its ordinary meaning.

The answer of the Circuit Court of Appeals to the point that the power is wanting was (R. 154):

> "It runs contrary to the language of the statute, the Treasury Regulations and judicial decisions relevant thereto."

This does not solve the problem. What "the language of the statute" means is the question. The Treasury Regulations, to be sure, assert the power, but the Regulations cannot establish the power if the statute has not granted it. Nor is there solution in "judicial decisions relevant thereto." There are none. No court until now has been called upon to examine the question. No court has.

Now that the question arises it should be answered.

II. IF POWER EXISTS, BY WHAT TESTS IS IT CONTROLLED?

The Regulations appear to say that compensation paid, as here, pursuant to a long-established plan, shall be allowed. Reg. 103, Section 19.23(a)-6(2), says:

> "Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered [here the bargain, except in the case of Gammel, was made *11 years* earlier, in 1931], not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual [it is not here claimed the agreement had any other purpose], it **should be allowed** as a deduction even though in the actual working out of the contract it may prove to be greater [it was not so here; see R. 162-4] than the amount which would ordinarily be paid."

The Tax Court, however, made the test of what was reasonable turn on:

1. **Source of the earnings**, mistakenly supposing that these were (R. 137) "abnormal war profits." They were not (see p. 8, *supra*). They were neither "abnormal" nor were they the product of "war" earnings. The company had none. Congress, moreover, has not made this the test of the taxpayer's deductions.

2. **Need of the United States for revenue**, because, otherwise (R. 138) "the Government, at a time when it needs tax income most vitally, will be unjustly deprived of such income." The tax cannot be made to turn on the nation's need "however great," as this Court had occasion to note in *Louisville Joint Stock Land Bank v. Radford* (1935), 295 U. S. 555, 602, a different case but involving the same monstrous doctrine. Moreover, Congress has not made "need" the test.

3. **A different rule in wartime**, the Tax Court mistakenly supposing (R. 134) that the ordinary tests do not apply. The short answer is that, Congress not having chosen to change the law for taxpayers generally, except through the device of the Renegotiation Act, the Tax Court had not the right to make the change for it.

But for these mistaken views of what the law permits, the Tax Court would have decided the case otherwise. It said as much (R. 133-8).

The Circuit Court of Appeals found in this nothing (R. 154):

> "of which petitioner may complain. The Tax Court was dealing with a question of fact."

To be sure, it was dealing with a question of fact. But to the solution of that problem it applied principles of law which never heretofore have been given the sanction of *any* court.

The Circuit Court of Appeals compounded the error by adding (R. 155):

> "A principal factor in determining the reasonableness of compensation is the amount of compensation paid similar employees engaged in similar industries."

If this is the test to be applied, then, of a certainty, the judgment should be reversed. See R. 161-4.

In any event, before a rule so at odds with the philosophy of free enterprise as the doctrine the Circuit Court of Appeals espoused, that permissible compensation is to be reduced to the dead level of what others pay—and here petitioner has been reduced far below that level (R. 162-4) —is written into law, the question should have the scrutiny of this Court.

The need is the greater since this Court never has had occasion to examine the principles which should control the exercise of so great a power as the Commissioner

has assumed, if, indeed, he has it at all, and which bulks so large in the day-to-day administration of the revenue laws. That guidance is needed, this case shows.

The writ should issue.

Respectfully submitted,

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CHARLES DEWOODY,
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September 13, 1948.

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In the Supreme Court of the United States

OCTOBER TERM, 1948.

No. 280

THE LOCKE MACHINE COMPANY,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITIONER'S REPLY BRIEF UPON PETITION FOR WRIT OF CERTIORARI.

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October 22, 1948.

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In the Supreme Court of the United States

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THE LOCKE MACHINE COMPANY,
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PETITIONER'S REPLY BRIEF UPON PETITION FOR WRIT OF CERTIORARI.

One would suppose from a reading of the Commissioner's brief opposing allowance of the writ that the question here is whether the taxpayer has justified as reasonable the sums it paid to the four individuals in question.

That is not this case.

The question here is:

1. Does the statute, properly read, bestow upon the Commissioner or the Tax Court, power to disallow part of a payment conceded to be compensation, on the ground the taxpayer paid too much?

   This question has never been passed upon by this or any other court. The question is one of first impression.

2. If the statute does bestow the power, has the issue whether the sums paid were reasonable been resolved by application of mistaken rules of law?

   Although compensation cases constitute the largest single class of litigation before the Tax Court, this Court has never had occasion to pass

upon the tests by which the power, if it exists, shall be controlled.

Once the Commissioner's extended effort to convert these—which are pure questions of law—into questions of fact, is put aside, it will be seen that his answer to the taxpayer's argument that the statute does not, and never was intended to, bestow the power the Commissioner has come to exercise thereunder, reduces to two points.

1. Argument Based upon Reenactment Cannot Give Act Meaning Words and History Deny.

The Commissioner's first reliance is the reenactment argument (Commissioner's brief, p. 7). The Commissioner having seized the power, Congress, having done nothing about it, is to be deemed to have approved. This is to "walk on quicksand," as the Court noted in *Helvering v. Hallock* (1940), 309 U. S. 106, 121.

The resort to presumed congressional approval would hardly seem enough to overbalance the teaching of the statute itself and its history (see petitioner's opening brief, pp. 12-18), as *Girouard v. United States* (1946), 328 U. S. 61, shows. Erroneous misconstruction, persevered in for no matter how long, cannot add to a statute what the Congress did not put there. This is the teaching of the cases. Recall for example:

Erie Railroad Co. v. Tompkins (1938), 304 U. S. 64, where, after nearly a hundred years and many sessions of the Congress, the Court gave to the statute there involved the meaning the Court was convinced Congress originally intended the statute to have.

Neirbo v. Bethlehem Shipbuilding Corp., Ltd. (1939), 308 U. S. 165, where a statute, which had survived nearly 100 years of repeated attempts at legislative change, was given a meaning the Court considered in harmony with the congressional intent.

City Bank Farmers Trust Co. v. Helvering (1941), 313 U. S. 121, where, although the statute had been reenacted 12 times, the Court rejected the construction put upon it by the Commissioner.

Here, it must be remembered, the question as to the meaning of the statute arises for the first time. The question comes unencumbered by any decision fixing upon the statute a meaning contrary to that disclosed by its history.

2. Where Sum Paid Is Admittedly Compensation Paid in Good Faith, Power to Disallow Ends.

The Commissioner's second point (Commissioner's brief, pp. 9, 11) is that, if petitioner's argument is sustained, then the taxpayer becomes the sole judge of the amount he may pay his employees.

Why not?

He is the "sole judge" of the amount in the case of every other business expense.[1]

---

[1] The Commissioner hints, but does not expressly say (Commissioner's brief, p. 10, note 7), that other deductions are subject to the test of "reasonableness" as to amount. This is not so (see petitioner's opening brief, p. 17, note 7). In *Commissioner v. Flowers* (1946), 326 U. S. 465, relied upon by the Commissioner, the traveling expense was not disallowed because it was unreasonable in amount; it was disallowed because it was a class or kind of expenditure which was not allowable under the statute. The case lends no support to the doctrine that the Commissioner could object to the payment of $4.03 for a lower berth when an upper could be had for $2.99. And yet that is precisely the kind of power the Commissioner claims to exercise when he says, as to Otto Gammel for example, that the taxpayer should have paid him, a certified public accountant devoting his full time to the taxpayer's business, only $3,500.

Limericks, Inc. v. Commissioner (5 C. C. A., 1948), 165 F. (2d) 483, also relied upon by the Commissioner, is likewise a different case. There, the Tax Court, having held that payments masquerading (7 T. C. 1129, at 1136) "under the designation of rent were in truth and in fact distributions of dividends," disallowed them, and the reviewing court affirmed. The question, said the reviewing court, was whether amounts paid as rent (165 F. (2d) 483, at 484) "constituted in reality a distribution of profits."

The Commissioner can, of course, always challenge a payment if it is not what it purports to be. But that is not this case. Here it is conceded that what the taxpayer paid was compensation. It was disallowed solely on the ground that the taxpayer paid too much—even though fixed pursuant to a plan going back ten years.

Nor does the requirement that only "ordinary and necessary" expenses (Commissioner's brief, pp. 9, 11) are allowable affect this case. As Dean Griswold has pointed out, 56 HARVARD LAW REVIEW 1142, 1145:

> "It is true that the expenses must be 'ordinary and necessary,' but these words are given full and adequate function when they are used to separate capital expenditures from current expenses, on the one hand, and when they eliminate such things as illegal expenditures or wholly unrelated expenses, on the other."

CONCLUSION.

If the taxpayer's reading of the statute is correct—and the Commissioner advances nothing to prove it wrong—then there has been a seizure of enormous power by the Commissioner. A power so vast should not pass by default.

The question is of obvious importance.

It should have the attention of this Court.

The writ should issue.

Respectfully submitted,

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October 22, 1948.

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In the Supreme Court of the United States

OCTOBER TERM, 1948

No. 280

THE LOCKE MACHINE COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum opinion of the Tax Court (R. 128-141) is not reported. The opinion of the Court of Appeals (R. 153-155) is reported in 168 F. 2d 21.

JURISDICTION

The judgment of the Court of Appeals was entered May 17, 1948. (R. 151.) The taxpayer's petition for rehearing was denied June 21, 1948. (R. 171.) The petition for a writ of certiorari was filed September 16, 1948. The jurisdiction

of this Court is invoked under 28 U. S. C.

QUESTION PRESENTED

Whether the court below erred in affirming the Tax Court's decision that a portion of the amounts claimed by taxpayer corporation under Section 23(a)(1)(A) of the Internal Revenue Code as deductions for compensation paid to its four executives-stockholders in 1941 was unreasonable.

STATUTE AND REGULATIONS INVOLVED

These appear in the Appendix, infra, pp. 16-19.

STATEMENT

The facts as stipulated (R. 14-34) and found by the Tax Court (R. 128-133) may be summarized as follows:

Taxpayer corporation manufactures and sells screw machine products and coaster brakes. Until 1941 (the taxable year) it sold its brakes through a brokerage company; early in that year Sears Roebuck Company took over the business of the brokerage company and placed an order with taxpayer for all the brakes it could manufacture. (R. 129-130, 137.) Taxpayer's sales, operating profits, and percent of dividends to capital stock from 1938 to 1941, inclusive, were as follows (R. 129):

	1938	1939	1940	1941
Net Sales	$209,096.89	$384,557.14	$332,156.17	$714,963.48
Operating Profit	$ 12,370.46	$ 60,033.55	$ 45,529.85	$176,796.31
Per Cent of Dividends to Capital Stock	6%	30%	10%	25%

E. H. Baker, Jr., vice president and general manager of taxpayer, had been associated with the company since 1919, during which time the company had steadily prospered. J. E. Tomer, secretary and assistant treasurer, had been associated with taxpayer since 1922. E. C. Sinclair, plant superintendent, had been with the company since 1928. Otto Gammel, office manager, first entered taxpayer's employ in 1934 as an accountant. At the beginning of 1941 Baker and his mother respectively owned 330 and 252 shares (a total of 582) of the 675 shares of taxpayer's stock; his mother died in March of that year and bequeathed all her stock to him. Tomer, Sinclair and Gammel each owned 10 shares of taxpayer's stock at the beginning of 1941, and 27 shares at the end of the year. Tomer and Sinclair were also directors of taxpayer. (R. 130-131.)

In 1927 taxpayer adopted a plan of compensating certain of its executive employees by payment of a bonus in addition to regular salaries. The bonus consisted of a percentage of taxpayer's profits, after setting aside an amount equal to 10 percent of the capital stock. Prior to 1941 the bonus amounted to 27 percent, allocated 10 percent to Baker, 9 percent to Sinclair and 8 percent to Tomer. At the beginning of 1941 Gammel threatened to leave taxpayer's employ unless he participated in bonus payments. In April of 1941 the bonus fund was accordingly raised from 27

percent to 29 percent, of which 9 percent was allocated to Baker, 8 percent to Sinclair, 7 percent to Tomer, and 5 percent to Gammel. At the same time the basic salaries of these four executives were raised as follows: Baker, from $9,600 to $15,000 (a $5,400 increase); Sinclair, from $4,320 to $4,920 (a $600 increase); Tomer, from $3,600 to $4,080 (a $480 increase); and Gammel, from $2,686.60 to $2,760 (a $73.40 increase). (R. 130, 131-132.) The fixed salary and bonus payments to these four individuals for the years 1938 to 1941, inclusive, were as follows (R. 130):

	1938	1939	1940	1941
E. H. Baker, Jr.				
Salary	$9,600.00	$ 9,600.00	$ 9,600.00	$15,000.00
Bonus	390.73	4,648.65	3,392.71	14,038.84
Total	$9,990.73	$14,248.65	$12,992.71	$29,038.84
J. E. Tomer				
Salary	$3,600.00	$ 3,600.00	$ 3,600.00	$ 4,080.00
Bonus	312.58	3,718.91	2,714.17	10,919.09
Total	$3,912.58	$ 7,318.91	$ 6,314.17	$14,999.09
E. C. Sinclair				
Salary	$4,320.00	$ 4,320.00	$ 4,320.00	$ 4,920.00
Bonus	351.66	4,183.78	3,053.44	12,478.97
Total	$4,671.66	$ 8,503.78	$ 7,373.44	$17,398.97
O. Gammel				
Salary	$2,242.60	$ 2,449.62	$ 2,686.60	$ 2,760.00
Bonus	.....	.....	.....	7,799.35
Total	$2,242.60	$ 2,449.62	$ 2,686.60	$10,559.35

There was no increase in the services or responsibilities of Baker and Tomer during 1941. Baker, who received the largest salary increase, spent three months of the year in California. There was some increase in the services and duties of Sinclair and Gammel, but this was far out of proportion

to the increase in their salaries. (R. 135, 137, 138-139.) Taxpayer offered no testimony whatever of salaries paid for like services by other enterprises engaged in similar businesses. (R. 137.) The increase in salaries for 1941 was based almost wholly upon taxpayer's increased profits resulting from the war demand for its products. In April of 1941, when the increases were voted, taxpayer anticipated large and unusual profits for that year. (R. 137.)

Taxpayer deducted from its 1941 gross income a total of $71,996.25 as compensation paid to its four executive employees (R. 128), as compared with a total of $29,366.92 for the preceding year (R. 130), and the Commissioner allowed a total of $36,500 as reasonable (R. 129). For Baker taxpayer deducted $29,038.84 in 1941 (as compared with $12,992.71 for 1940), and the Commissioner allowed $16,000. For Tomer it deducted $14,999.09 in 1941 (as compared with $6,314.17 for 1940), and the Commissioner allowed $8,000. For Sinclair it deducted $17,398.97 in 1941 (as compared with $7,373.44 for 1940), and the Commissioner allowed $9,000. For Gammel it deducted $10,559.35 in 1941 (as compared with $2,686.60 for 1940), and the Commissioner allowed $3,500. (R. 129, 130.) The Tax Court sustained the Commissioner's determination as to Baker and Tomer, but overruled his determination in part by increasing the allowance for Sinclair by $1,000 and

for Gammel by $4,000, resulting in a total allowance by the Tax Court of $41,500. (R. 138-139.) It concluded that taxpayer had failed to prove the reasonableness of payments larger than those amounts. Taxpayer appealed from that portion of the Tax Court's decision which was adverse to it, and the Court of Appeals affirmed. (R. 153-155.)

ARGUMENT

1. Section 23(a)(1)(A) of the Internal Revenue Code (Appendix, *infra*), authorizes the deduction from gross income of "ordinary and necessary" business expenses "paid or incurred" during the taxable year, "including a reasonable allowance for salaries or other compensation", traveling expenses, and rental payments. Section 19.23(a)-6 of Treasury Regulations 103 under the Code (Appendix, *infra*), which is the same as those under prior Acts,[1] provides *inter alia* that "The test of deductibility in the case of compensation payments is whether they are reasonable". Section 19.23(a)-8 of the Regulations (Appendix, *infra*), which is also the same as those under prior Acts,[2] provides that "bonuses" to employees are

[1] Section 19.23(a)-6 of Regulations 103 under the Code is the same as Article 23(a)-6 of Regulations 101 (1938 Act), Regulations 94 (1936 Act), and Regulations 86 (1934 Act). It is substantially the same as Article 126 of Regulations 77 (1932 Act) and Regulations 74 (1928 Act), Article 106 of Regulations 69 (1926 Act) and Regulations 65 (1924 Act), and Article 105 of Regulations 62 (1921 Act), and Regulations 45 (1918 Act).

[2] Section 19.23(a)-8 of Regulations 103 under the Code is the same as Article 23(a)-8 of Regulations 101 (1938 Act),

deductible "provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered." Since the statutory provisions to which these Regulations are addressed have been reenacted in the successive Revenue Acts since 1918,[3] the Regulations must be "deemed to possess implied legislative approval and to have the effect of law". *Commissioner* v. *Flowers*, 326 U. S. 465, 469. See also *Boehm* v. *Commissioner*, 326 U. S. 287, rehearing denied, 326 U. S. 811; *Helvering* v. *Winmill*, 305 U. S. 79.

In harmony with the statutes and the long-standing Regulations, the courts, in a multitude of cases involving the question here presented, have uniformly held that (1) to qualify for deduction under Section 23(a) a salary payment must be reasonable in amount; (2) how much is reasonable presents a question of fact in each case; (3) the Commissioner's determination is presumptively correct, the taxpayer having the burden of proving the reasonableness of the

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Regulations 94 (1936 Act), and Regulations 86 (1934 Act); Article 128 of Regulations 77 (1932 Act) and Regulations 74 (1928 Act); Article 108 of Regulations 69 (1926 Act) and Regulations 65 (1924 Act). It is substantially the same as Article 107 of Regulations 62 (1921 Act), and Regulations 45 (1918 Act), and Article 138 of Regulations 33 (1916 Act).

[3] Code Section 23(a)(1)(A), with the exception of the caption, is the same as Section 23(a)(1) of the 1938 Act; Section 23(a) of the 1936, 1934, 1932 and 1928 Acts; and Section 214(a)(1) of the 1926, 1924, and 1921 Acts. Except for the traveling expense clause (inserted in the 1921 Act), it is also the same as Section 214(a)(1) of the 1918 Act.

claimed amount; and (4) the Tax Court's finding (upon review of the Commissioner's determination) of the amount constituting reasonable compensation is conclusive on appeal if supported by substantial evidence, or if the taxpayer's evidence is too weak to carry the burden resting on it. And in each instance in which the taxpayer has sought certiorari, this Court has denied further review.[4] Nothing has occurred since the denial of certiorari in those cases which calls for further review of this case.

2. Taxpayer does not and cannot assert conflict with any decisions of this Court or any other court. Relying upon Treasury Regulations which have no relevancy here,[5] it contends (Pet. 5-7, Br.

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[4] *Long Island Drug Co.* v. *Commissioner*, 111 F. 2d 593 (C.C.A. 2d), certiorari denied, 311 U. S. 680; *L. & C. Mayers Co.* v. *Commissioner*, 131 F. 2d 309 (C.C.A. 2d), certiorari denied, 318 U. S. 773; *Gem Jewelry Co.* v. *Commissioner*, 165 F. 2d 991 (C.C.A. 5th), certiorari denied, 334 U. S. 846; *Glenshaw Glass Co.* v. *Commissioner*, decided October 15, 1946 (1946 P-H T. C. Memorandum Decisions, ¶ 46,245), affirmed (C.C.A. 3d) October 21, 1947, certiorari denied, 333 U. S. 842; *L. E. Pinkham Med. Co.* v. *Commissioner*, 128 F. 2d 986 (C.C.A. 1st), certiorari denied, 317 U. S. 675; *Forest Products Chemical Co.* v. *Commissioner*, 27 B.T.A. 638, affirmed (C.C.A 6th) December 18, 1934, certiorari denied, 294 U. S. 726; *Smith* v. *Russell*, 76 F. 2d 91 (C.C.A. 8th), certiorari denied, 296 U. S. 614; *Kennington* v. *Donald*, 50 F. 2d 894 (C.C.A. 5th), certiorari denied, 284 U. S. 664; *Field & Start, Inc.* v. *Commissioner*, 17 B.T.A. 1206, affirmed, 44 F. 2d 1014 (C.C.A. 2d), certiorari denied, 283 U. S. 826.

[5] Regulations 41, relied upon by taxpayer (Br. 14), pertain solely to the excess profits tax imposed by the Revenue Act of 1917, c. 63, 40 Stat. 300. T. D. 2696, April 10, 1918 (20 Treasury Decisions 330), quoted in part by taxpayer (Br. 13, fn. 2) was superseded by Article 105 of Regulations 45 (1920 ed.) under the Revenue Act of 1918, which is the genesis of Section 19.23(a)-6 of Regulations 103 under the Code.

12-18) that the test of reasonableness prescribed by Section 23(a) applies to unpaid compensation, not to compensation paid in good faith; in short, that the taxpayer is the sole judge of the deductibility of its salary payments. As the court below observed (R. 154), the contention runs counter to the language of the statute, the long-standing implementing Regulations, and the applicable decisions.

The portion of Section 23(a) which authorizes the deduction of "a reasonable allowance for salaries or other compensation"—like the ensuing portions authorizing the deduction of travel and rent expenses—represents but "one of the specific examples given by Congress in that section of 'ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business' ". *Commissioner* v. *Flowers, supra,* p. 469; cf. *Helvering* v. *Morgan's, Inc.,* 293 U. S. 121. The phrase "paid or incurred during the taxable year", appearing in the omnibus portion of the section, relates to when (i. e., which taxable year) the business expense is deductible, not to whether it is deductible.[6] Though "paid or incurred", the expense must still be "ordinary" to be deductible. Even under the 1916 Act—before the compensation clause was added to the section—this Court held that "extravagant" compensa-

[6] Since taxpayer filed its returns on the accrual basis (R. 128) its allowable business expenses were deductible in the taxable year "incurred". See Code Sections 43, 48(c), (26 U.S.C. 1946 ed., Secs. 43, 48).

tion payments to corporate officers "cannot be regarded as 'ordinary and necessary expenses' ", and do not qualify for deduction "merely because the payments are made in accordance with an agreement between the corporation and its officers" and pursuant to an established bonus plan. *Botany Mills* v. *United States,* 278 U. S. 282, 292. See also *Long Island Drug Co.* v. *Commissioner,* 111 F. 2d 593 (C.C.A. 2d), certiorari denied, 311 U. S. 680. As taxpayer acknowledges (Br. 15-16), no change in allowable business expense deductions was intended by the insertion in the 1918 Act of the inclusionary clause relating to compensation. Certainly there is nothing in the legislative history of Section 23(a) to which taxpayer refers, or which we have discovered, which even remotely suggests that, merely because compensation is "paid or incurred" in good faith, it need not be "reasonable" to be allowable.[6a] This class of business expense is no more allowable simply because it is paid or incurred than any other.[7]

[6a] The note of Dean Griswold, in 56 Harv. L. Rev. 997 (1943), upon which taxpayer relies (Br. 16), states (p. 997) that the clause has "no legislative history" and "went through Congress without any specific consideration."

[7] Significantly, the traveling expense clause of Section 23(a) does not contain the word "reasonable", yet this Court has held that "The expense must be a reasonable and necessary traveling expense" to qualify for deduction under that section. *Commissioner* v. *Flowers, supra,* p. 470. And even though the rent clause of the section does not contain the word "reasonable", it has been held that "rentals or other payments for the use of property which are excessive in amount, taking into consideration all the facts of the particular case, do not constitute ordinary and necessary business expenses". *Limer-*

"The mere fact that the expense was incurred under contractual obligation does not of course make it the equivalent of a rightful deduction under Section 23(a)." *Interstate Transit Lines* v. *Commissioner,* 319 U. S. 590, 594. Similarly, the fact that an expense was "paid" in good faith —and even a "necessary" one—is not determinative *per se* of its deductibility. *Welch* v. *Helvering,* 290 U. S. 111.

To subscribe to taxpayer's novel construction of Section 23(a) would in effect erase the words "ordinary" and "reasonable" from the statute, disregard the long-standing Treasury Regulations which have received implied legislative approval, and upset two decades of administrative practice and court decisions. There would be no ceiling on salary deductions or, for that matter, on any other kind of business expense deduction claimed under Section 23(a); the taxpayer himself would become the sole judge of deductibility for tax purposes. It is inconceivable that Congress so intended. The test of deductibility under Section 23 is an objective rather than a subjective one. *Commissioner* v. *Flowers, supra; Welch* v. *Helvering, supra; Boehm* v. *Commissioner, supra.* Taxpayer is no more the exclusive and final judge of what is deductible from gross income under Section 23

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icks, Inc. v. *Commissioner,* 165 F. 2d 483, 484 (C.C.A. 5th). *A fortiori* compensation payments, which Congress has expressly stated must be "reasonable" to be "allowable", do not qualify for deduction unless they are reasonable in amount.

than, for example, of what is includible in gross income under Section 22. Indeed, the elementary rule that deductions are matters of legislative grace and that the taxpayer has the burden of clearly proving the Commissioner's determination, presumptively correct, to be wrong (*Welch* v. *Helvering, supra; Interstate Transit Lines* v. *Commissioner, supra; Deputy* v. *du Pont,* 308 U. S. 488), would become well-nigh meaningless if, as taxpayer urges, the Commissioner and the Tax Court are without power to question the reasonableness of a claimed salary deduction.

3. The record unquestionably warrants the Tax Court's determination (R. 138) that taxpayer failed to sustain the burden of proving the reasonableness of the claimed salary deductions. The compensation paid by taxpayer to its four executives for the taxable year (1941) was more than double the amount paid for the preceding year (R. 29, 130), and represented over 60 percent of its net profits before taxes (R. 33, 129).[8] The increase resulted partly from an increase in fixed salaries, and partly from payment of a bonus measured by a percentage of taxpayer's profits. (R. 132.) And the chief beneficiary of the increase was taxpayer's controlling stockholder,

[8] The claimed deductions for 1941 totaled $71,996.25, as compared with a total of $29,366.92 for 1940. (R. 29, 130.) Taxpayer's operating profit for 1941 amounted to $176,796.31, and its net profits before federal taxes amounted to $114,380.84. (R. 33, 129.)

Baker. (R. 131.) The Tax Court found (R. 135, 137, 138-139), and it is undisputed, that the services performed by two of the executives (Baker and Tomer) were no different in 1941 than in 1940; and while there was some enlargement of the responsibilities of the other two (Sinclair and Gammel), the Tax Court took this into account by raising the amount which the Commissioner had allowed for them. Moreover, the increase in fixed salaries was not awarded before the services were rendered, but in April of the taxable year (R. 132), after taxpayer obtained an order for all the coaster brakes it could produce and anticipated an unusually prosperous year (R. 130, 137). See Section 19.23(a)-6(2) of Regulations 103. What is more, the compensation was not fixed by an arm's-length bargain; the four recipients owned all but a few shares of taxpayer's stock, and two of them were also directors (R. 130-131), an important factor to be considered. *Crescent Bed Co.* v. *Commissioner,* 133 F. 2d 424 (C.C.A. 5th); Section 19.23(a)-6(2) of Regulations 103. Finally, taxpayer offered no testimony which would afford a comparison of the compensation paid with that paid "for like services by like enterprises under like circumstances". Section 19.23(a)-6(3) of Regulations 103. This was a serious deficiency in its proof. *Clinton Co.* v. *Commissioner,* 159 F. 2d 102 (C.C.A. 7th); *In re Rae's Estate,* 147 F. 2d 204 (C.C.A. 3d); *L. & C. Mayers Co.* v. *Commis-*

sioner, 131 F. 2d 309 (C.C.A. 2d); *Gem Jewelry Co.* v. *Commissioner,* 165 F. 2d 991 (C.C.A. 5th). In short, as the Tax Court noted (R. 137), the increased compensation was "based almost wholly upon the increased profits" of taxpayer. This factor, while relevant, is by no means conclusive of the reasonableness of the amount paid (*Clinton Co.* v. *Commissioner, supra*), especially where, as here (R. 134-137), the increase in profits was not attributable to increased services but to the war demand for taxpayer's products (*Miller Mfg. Co.* v. *Commissioner,* 149 F. 2d 421 (C.C.A. 4th)). Under the circumstances, the Tax Court was fully justified in concluding that taxpayer had failed to sustain the burden of proving that $71,996 compensation deducted from its 1941 gross income (as compared with $29,366 deducted in 1940 (R. 130)) represented reasonable compensation.

Taxpayer's contention (Pet. 7-8, Br. 19-20) that the Tax Court reached its decision by considering only the source of taxpayer's earnings and the Government's war-time need for revenues, is patently unfounded. As the affirming opinion below points out (R. 154-155), the contention rests upon taxpayer's self-serving interpretation of selected portions of the Tax Court's opinion, and disregards the plain tenor of the opinion as a whole. The undisputed evidentiary facts fully support the Tax Court's determination of the "reasonable" amounts deductible, and the court

below properly refused to substitute its own inference for that of the Tax Court. If there is any question which calls for application of the familiar rule that it is the Tax Court's function to find the facts and draw inferences from them, it is the recurrent one of what constitutes a "reasonable allowance" for compensation under Section 23(a).

CONCLUSION

The decision below is correct. The question presented is purely one of fact. There is no conflict, and no occasion for further review. The petition should therefore be denied.

Respectfully submitted,

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APPENDIX

Internal Revenue Code:

SEC. 23 [as amended by Sec. 121 of the Revenue Act of 1942, c. 619, 56 Stat. 798]. Deductions From Gross Income.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—

(1) *Trade or business expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * *

(26 U.S.C. 1946 ed., Sec. 23.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.23(a)-6. *Compensation for personal services.*—Among the ordinary and necessary

expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services. This test and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. (*a*) An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services, and the excessive payments correspond or bear a close relationship to the stock holdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. (*b*) An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business.

(2) The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

(3) In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is in general just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

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SEC. 19.23(a)-8. *Bonuses to employees.*— Bonuses to employees will constitute allowable deductions from gross income when such pay-

ments are made in good faith and as additional compensation for the services actually rendered by the employees, provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered. It is immaterial whether such bonuses are paid in cash or in kind or partly in cash and partly in kind. Donations made to employees and others, which do not have in them the element of compensation or are in excess of reasonable compensation for services, are not deductible from gross income.

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